BANKS - Money from nothing

"Bankers own the earth ... if you want to continue to be slaves ... then let bankers continue to create money and control credit."

Sir Josiah Stamp
one-time Governor of the Bank of England

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There was a time when the Church was the most powerful institution in Western Society and few questioned its right to be so. In some countries governments are still all powerful. In our society today, however, by far the most powerful institutions are banks, supported by a web of financial structures which reinforce this power. It is time we questioned their right to be so mighty and to ask whose interests they serve.

The media beguile us with the impression that politicians hold and wield the power, and we believe them. It is virtually impossible to escape hourly political and current affairs reports which reinforce this misconception. So vast and cleverly contrived is this mass of information that it is difficult to keep in touch with reality. Young people describe things that truly impress them as "unreal". How right they frequently are.

While we are thus preoccupied, bankers and financiers go about their business.

Most of us make extensive use of banks - they inevitably play an important part in our individual and collective lives. Like so many other things, we take our banking for granted, giving it little thought and scant examination. We seldom stop to consider its real nature or its cost to us individually or to the community at large. Many of us do not even examine our bank statements to make sure there are no errors on them. Few of us would have any knowledge of the nature and justification of charges we regularly meet, but we assume that it is all in order. We trust that interest is being charged at the right rates. Above all, we do not check our statement for deliberate fraud.

It would be foolish to argue that banking has no place in society. Quite obviously it is the powerhouse of modern commerce and must remain so. The real point is, however, that banking has two faces - one socially creative, the other devastatingly destructive. That of course gives rise to a number of challenges.

The first and most demanding is to put in place that model of banking which serves the best interest of Australia. One which is socially creative and not destructive. This is the responsibility of government - and only courageous governments will do it. We do not have courageous government in Australia and there is none in sight.

The second is that, having built the best banking system possible, we should ensure that no-one destroys it, either deliberately or by neglect. Both have happened in Australia in our lifetimes.

The third challenge is to expose and remove people, be they bankers, treasurers, business people, politicians or whoever, who abuse the system for their own ends or neglect their responsibilities to it. I have given evidence that such abuse and neglect is rampant in Australia today, indeed throughout banking around the world, and that there is little will to reduce this.

It is abundantly clear that banking can help us create a truly free and prosperous society, but it is not doing so. It is equally clear that abuse of banking practice is a major factor in the degeneration of our nation.

How great a hold do banks have over us? To answer this question and to appreciate the potency of the answer, let's start from absolute basics.

Let's consider this. When banks lend us money, (give us credit), we go into their debt. Of course, you say. The bank argues that since it is taking the risk of lending us money, (extending us credit), they require some security. So we put an asset on the line such as our home, our business or our farm. The bank then says it deserves a regular fee for its risk taking and for providing credit. That fee is interest, although other fees, such as establishment and management fees are also charged. Finally, the bank requires that if we cannot meet the agreement then they are entitled to any home, business, farm or other real asset that we may have put up as collateral.

This is a simplified but reasonable accurate description of a bank's money-lending function and of how it goes about it. Let's look at it in detail under three headings: credit, collateral and interest.

CREDIT

When banks give us a loan, does it actually cost them anything? Curiously, it costs them virtually nothing. This is the special privilege of the banker - the privilege of creating credit.

Many years ago, a report commissioned by the British Government summarised it like this:

> It is not unusual to think of the deposits of a bank as being created by the public, through the deposit of cash representing savings or amounts which are not for the the time being required to meet expenditure. But the bulk of the deposits arise out of the actions of the banks themselves, for by granting loans, allowing money to be drawn on an overdraft, or purchasing securities, a bank creates a credit in its books which is the equivalent of a deposit. *(The Macmillan Report, 1929-31, Inquiry into Banking and Finance and Credit, p.34, para. 74)*

Here is the crunch concept - the one we must grasp if we are to truly comprehend the power of banks. Most of us imagine that, when we borrow from a bank, somewhere out in a back room, someone is pairing off our need for an overdraft with somebody else's deposit. We are not so naive as to think that they are counting real, touchable money, and moving it from one persons pile to another. But at least we think that the bank must borrow before it lends.

So banks have this great privilege - that of creating money and credit. By the exercise of that power, banks determine who sinks and who swims, who eats and who starves, who lives in luxury and who in poverty.

But no. The money does not need to exist either in a real, touchable sense or in any other sense. After our interview with the credit manager we walk away and begin to write cheques or use our credit card. All that happens in the back room is that entries are made in books. Nothing more than ink on paper. Even simpler these days - nothing more than the click of computer keys.

John Kenneth Galbraith, one of the most eminent and respected modern economists, wrote a book with the simple title, *Money*. In it he writes:

> The process by which banks create money is so simple that the mind is repelled. Where something so important is involved, a deeper mystery seems only decent.

Graham Towers, the Governor of the Central Bank of Canada put it bluntly when asked how banks create money and credit:

> The ... process consists of making a written or typed entry on a card. That is all. *(Testimony to the Canadian Committee on Banking and Commerce, Inquiry of 1939)*

That was 1939. Clicking today's computer keys makes it easier still.

Is there any limit on the amount they can create? In July 1991, the Joint National Secretary of the Finance Sector Union of Australia wrote this:

> On the basis of advice received from the research department of the Reserve Bank of Australia Bulletin ... we are able to inform you that in Australia the creation of money is achieved by the following equation: M3 divided by Base Money. The result of the equation is a figure close to 14. All banks in Australia create money in this way with creation based on the level of demand. The Reserve Bank has some authority over this process, but not complete authority. *(Extract from a letter from L.N. Hingley, Joint National Secretary Finance Sector Union of Australia, to L.F. Hoins, 22 July 1991; my italics)*

If the 'equation' doesn't make much sense, don't worry. We'll come to that next. The crucial words are the ones in italics. *Banks create money with creation based on the level of demand.* If they want more, they just create more.

The only limitations are those of prudence and statutory rules. In March 1988, a General Manager of the National Australia Bank wrote this clear summary of the limitation in Australia today:

> The process ... is called 'create creation' and is the basic process by which deposits and lending are connected in all lending systems.
>
> There are 2 factors that influence the ability of a lending body to create credit:-
>
> 1. A gearing limitation - that is the statutory (in most countries) or the prudential limit to which the financial intermediary can gear its capital. Expressed another way this is the amount of capital that must back up each loan.
>
> At present Australian banks have a gearing imposed of 6.0% which in simple terms means that for every $100 of loans the Bank must have $6 of capital.
>
> With finance companies gearing levels are usually set in their trust deeds. In the past gearing ratios of 8 to 1 were common (ie $8 of loan for each $1 of capital but over time that has moved out to be closer to 15 to 1) ...

This is the 'equation: M3 over base money' Mr Hingley was talking about. The summary goes on:

> 2. A liquidity limitation - for example, Australian banks must keep 7% of their deposits in Statutory Reserve Deposit account with the Reserve Bank and also maintain a Prime Asset Ratio of 12%. The latter means that each Bank must have cash, Bonds, Treasury Notes, etc which represent 12% of their assets. On top of these constraints the Bank must also have enough liquid assets to meet any movements in the ebb and flow of money - naturally those sums can't be lent to customers. There are varying such requirements in countries around the world. *(Extract from a letter from D.M. Cowper, General Manager National Australia Bank, to O.K. Fauser, 21 March 1988).*

That is the most lucid statement of the current Australian situation that I have ever seen. And all this is enshrined in law. The Treasurer of Australia wrote to me in 1991, saying:

> Various rights and duties have been conferred on banks by legislation, the most important of which is the exclusive operation of the payments system and the unique ability to create credit. *(Document 4A)*

It might seem, then, that there should be no doubt about the fact that credit creation exists and how it is limited. Yet there are people who deny it.

Mr. Alan Cullen, Executive Officer of the Australian Bankers Association and spokesman for Australia's largest banks, made this statement as recently as November 1991:

> Credit creation is a sort of old fashioned religious idea. *(Statement made during an ABC (SA Regional) debate with Paul McLean concerning the Report of the Martin Committee, 27 Nov 1991).*

Deny it as he might, there can be no doubt that *credit is not restricted by the amount the banks have in their vaults.*

But back to the day you get your loan. The bank attends to these entries in its double entry books of accounts. Its accounts are in balance. You are in debt to the bank and the bank has given you the green light to go out and do some spending. You can draw it out in cash, but the vast majority of transactions will probably occur on paper (for example, cheques) or via electronic transfer (credit cards, EFTPOS and so on).

But, says the bank, you are forgetting the question of liquidity. It will be our money you draw out, as you have not yet paid any in. True. But what happens to it next? You write some cheques, use the credit card, and spend the cash. All of this goes into the tills of the people you pay it to. And where do they put it at the end of the day? Back in the bank, of course. Not necessarily your bank, but back into the banking system.

If the banks have issued a total of a million dollars in new credits one day, they will have a million dollars in extra deposits the next. And unless something very odd is happening, your own bank will have roughly equivalent shares of both the new credits and the extra deposits. Thus they have only had to use their own money for a few hours, and back it comes. In other words, under normal circumstances, bank liquidity corrects itself just as surely as their balance sheets do.

This is why the total amount of credit advanced by all the banks to all their customers can go up and down from day to day, why we can have credit squeezes and credit expansions, all without the banks losing liquidity or unbalancing their balance sheets.

But there is a very big difference between the bank's circumstances and yours. When you got your overdraft, what the bank gave you it created with the stroke of a pen, a click of computer keys, ink on paper; what you give back to the bank you earn by your talent, labour, sweat of your brow and risk of your assets.

Even though the purchasing power you now have was created by the bank out of thin air, you as sure as hell are in their debt, and the bank may well have control of a real asset of yours which you were required to offer as collateral.

So banks have this great privilege - that of creating money and credit. By the exercise of that power banks determine who sinks and who swims, who eats and who starves, who lives in luxury and who in poverty.

... realise that the vast majority of everything you look at is in hock to banks - homes, farms, factories, businesses, cars, boats, TVs - almost everything. And all in exchange for what banks create out of thin air.

COLLATERAL

When it lends us money, does the bank put itself at risk? If it has lent prudently, (that is to someone who will be able to repay and honest enough not to abscond), there is every chance they will pay the loan back. Does the bank then actually need to have our home, business or farm as collateral? Only if it does not trust its own judgement. Demanding collateral is a wonderful way of avoiding the need to be prudent and wise, so they demand it all the time.

This represents a real risk to the borrower. Just as banks can create credit by the click of computer keys, so also they can contract or destroy credit by calling in loans. Experience indicates that there are cycles of credit expansion and credit contraction. Ordinary people and their debts are caught in these cycles irrespective of anything they may have done or not done, and for them the consequences can be great.

There are very few people or businesses which could immediately find the money to pay off all their debts and mortgages. They could not find the money immediately even in the best of times, and if times are tough it is still more difficult. So the bank may move in, sell their collateral assets for fire-sale prices, and leave them destitute.

Of course, this does not mean that every bank foreclosure is unreasonable. But unreasonable foreclosure is the most common malpractice reported to me as a bank-watcher.

Often, the foreclosure is not part of a general credit squeeze, but is imposed by a bank on a single business. This, too, is not necessarily unreasonable. If they have good reason to believe that a business is going bad, banks have to try to get their money out like anyone else. However, thanks to having demanded guarantees, mortgages, floating charges and other forms of collateral, banks are the least likely to lose in any normal business failure. More often, they walk off with all the assets, leaving hundreds of small trade creditors with nothing, so all sorts of innocent third parties are caught in the net.

Despite all these privileges, however, banks have managed to run up mountains of bad debts. How? It is very easy if you are stupid enough, and lending large sums to irresponsible entrepreneurs is a very good start.

All the honest depositors and borrowers of Australia are suffering today because our banks have been in the hands of people who were incapable of recognising a shonky deal when they saw one. These bankers, greedy for a bigger share of the financial market, gave credit to people who were simply corporate raiders, people who were not building genuine businesses or doing anything for the well-being of the community. Bank financed takeover bids did immeasurable harm to many of our greatest companies, while the subsequent corporate collapses left the banks with bad debts which they then claimed as tax deductions, making the taxpayer pick up the bill for 39% of the cost of their folly. They then charged the rest to their surviving customers in increased charges and continuing exorbitant interest rates.

All these bad debts were supposed to have collateral backing, but when the chips were down the collateral was insufficient. How this happened is an object lesson for anyone who believes either in market values or the acumen of the banks. Let us suppose that Fred wanted to buy a television station for $1.2billion. He went to a bank for a loan. They asked for collateral, whereupon he offered the TV station he was buying. They checked the market and found that he had offered $1.2billion. To the market value addicts, this was the latest price and hence what the TV station was 'worth' as collateral. So Fred got the loan. What price the Clever Country when people of such paralysed intellect are holding the reins?

These were the people who were determining the economic future of the country. It was the bankers, not the government who decided that the corporate raiders should be bank-rolled and productive industry starved. It was the bankers who created a climate where Australian inventions and innovations of real commercial value have had to be sold to overseas manufacturers for exploitation. "Too risky", they chanted, and rushed off to their appointments with Christopher Skase.

What is worse, these people have not had the decency to crawl away under a stone and die. Look at the names of the people who were running the banks in the late eighties, when the mountains of debt were piled up. They are still in their boardrooms, blaming everyone but themselves for the results of their incompetence.

Perhaps they aren't just bastards after all, but stupid bastards.

The enormity of this power of credit creation and collateralisation of assets is itself stunning, but when one realises how and why it can be used then the situation becomes even more frightening.

Just think about this. Almost all real property in our society is collateralised to banks. In other words it is in 'hock'. When you next look out of your window across our great cities and towns and rolling hills, realise that the vast majority of everything you look at is in hock to banks - homes, farms, factories, businesses, cars, boats, TVs -almost everything. And all in exchange for what banks create out of thin air.

When next you walk the streets of a major city note how many bank buildings there are. Corner after corner is occupied by huge highrises bearing the names of our masters. Note also the buildings of their subsidiary finance and insurance companies. Then remember that almost all other buildings that do not bear their names are also collateralised to them by their owners.

Several important question arise at this point.

First, is credit so bad? Of course not. It gives rise to actual purchasing power and much of it is exchanged for real goods and services. Without it, it would be very difficult for anyone without capital to establish a business, so the rich would remain in charge and the poor would remain poor. Credit is one of the agents of social mobility. But delivering the power to create and distribute it into the hands of private banks is fraught with danger.

It was the awesomness and potential abuse of this power that caused Thomas Jefferson to say, two centuries ago:

> I believe that banking institutions are more dangerous to our liberties than standing armies.

Not only is it dangerous. It also means abandoning one of the most powerful tools of a nation's control over its own destiny. Little wonder that Mayer Amschel Rothschild, the founding father of one of the greatest and wealthiest banking families in history said this:

> Permit me to issue and control the money of a nation and I care not who makes its laws.

Abraham Lincoln thought he had the answer:

> The government should create, issue and circulate all the currency and credit needed to satisfy the spending power of the government and the buying power of consumers. The privilege of creating and issuing money is not only the supreme prerogative of government, but it is the government's greatest creative opportunity.

And it was this realisation that caused the founding fathers of the Commonwealth of Australia to create a banking system designed to match Lincoln's dream.

What, then, will history say of those who, in the name of deregulation, systematically and deliberately weakened public control and supervision?

The implications of what has been described are that most real property and resources of the world are now in the control of banks. As financiers have increased the availability of credit to individuals, businesses, institutions and governments, so in turn they have increased their control and power.

Permit me to issue and control the money of a nation and I care not who makes its laws.

Mayer Amschel Rothschild

Because they are inextricably linked, the explosion of credit in recent decades has also been an explosion of debt. Much of the world's productive effort and resources are consumed in servicing the interest and other costs of this deliberately created debt and much of our productive effort is to avoid foreclosure and the loss of collateralised assets.

Moreover, as banking has become global the web of debt now spans oceans and continents. With growing internationalism have come the challenges inherent in the uneven distribution of the world's resources and wealth and the vastly complicated question of international lending, exploitation and indebtedness. Bankruptcy allows an 'out' for individuals and corporations so they may escape permanent debt if they are prepared to part with their assets, but sovereign debt, (the debts of states and nations), is much more difficult to throw off.

In the complex world of international currency dealings, countries which have entered into debt in their own currencies have been able to reduce the damage of their debt by deliberate devaluation of their domestic currencies. However, where debt is in other denominations, as is the case with the greater part of our own national debt, this cannot be readily done.

Furthermore, the international banking community is more willing to accommodate those countries whose monetary policies are judged to be prudent or responsible. This sounds fine. But what is prudence and responsibility? International bankers know the answer: deregulation and free market economics. Such policies are of unquestioned advantage to the bankers themselves but less obviously so the workers of Venezuela, Brazil or, God help us, Australia.

If this is so with business, commercial and sovereign debt, it is much the same for the private individual. Just as all credit is not destructive nor therefore is all debt. Where we can comfortably service debt it works for us in expanding purchasing power and access to resources for a wide variety of uses. Both the degree and nature of indebtedness are therefore important considerations. How we cope with our debt is what is most important. Moderate debt under control is socially creative; debt out of control is socially destructive.

Although individuals may escape unmanageable debt by opting for bankruptcy, this means that the collateralised assets change hands. Governments therefore, have an obligation to create constructive coping mechanisms in the form of compassionate and just bankruptcy laws.

Australian governments have been weak in this law-making role, just as they have been weak in monitoring the system at large, and so Australians, both individually and collectively, are frequently at the mercy of creditors. In efforts to avoid bankruptcy and to retain their assets they frequently commit themselves and their families to virtual permanent indebtedness. For the more fortunate debt may be transient and short lived, but for many it has become permanent. It is their slavery.

INTEREST

The final question in this chapter is that of interest rates. It is this area probably more than any other which concerns ordinary Australians. This is for two reasons; interest is what they have to meet month by month, and it is interest charges that determine whether they sink or swim - whether they save their assets or go under to the bank. Of course, those who have money to invest welcome high interest rates; but, overall, the prosperity both of individual Australians and of our business enterprises is promoted by lower interest rates.

In its simplest terms, interest is the price of hiring money. Just as you pay a charge for the use of a rented car, so you pay a charge for the use of rented money. And it has been mighty expensive in Australia in recent times. Australians, from the mid '80s through until mid '91, were paying between 13-18% for home mortgages, 18-24% for overdraft funds, 20-25% for rural short term finance, 20-25% on credit card finance and 18-25% on lease and hire purchase finance. Additionally, a range of management charges applied in many cases. Often rates were subject to variation without notice or agreement and borrowers were frequently not clear as to what rates they were paying or what charges applied until they were levied.

By world standards these levels were exorbitant. What, then, is fair?

It is generally reckoned that, in a 'free' money market, the base rate of interest will be between 2 and 3% above inflation. It never works quite like this, however, because the market may take a longer view. There was a period, in fact, when Australian interest rates were actually less than inflation, but this was because the market expected (rightly) that inflation would soon come down. As it did so, the rates dropped, but not as fast as inflation. This, too is to be expected.

At the time I write, however, inflation has been at a rate of 3-4% per annum for two years. This should be long enough for interest rates to come down to match, and would make a 'reasonable' base rate of 5-7%. But they are standing at 8-9% and show no indication of coming down.

When, Congressman Henry Gonzales, Chairman of the US Congressional Committee on Banking, learned of the level of charging by Australian banks he commented, "Any country which tolerates usury cannot prosper". (Comment made to Paul McLean at a breakfast meeting in Washington DC, on July 19th 1991).

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Usury originally meant 'lending money at exorbitant interest', and this is what Congressman Gonzales meant. How right he was. Australia has tolerated usury and has not prospered because of it.

The next reason for variation in interest rates is the variation in the risk to the lender. Thus the base rate applies to loans where there is assumed to be no risk at all. The extra percentage is then like an insurance premium which you pay for to insure that bank against the risk of not getting their money back. This sounds fair enough, but it results in a Catch 22 situation: if your capacity to repay is in doubt, you are charged extra interest to cover the risk. But if you are a bad risk, the higher interest rate will make you a worse one.

This is the source of one of the most blatant bank malpractices. Say you go to them for a housing loan - normally one of the safest and hence cheapest loans a bank offers. They know that their money is safe with you, but they want to get a higher interest rate. So they refuse the housing loan, but instead offer you an overdraft or a personal loan, with a lien on your assets as collateral. You are then paying overdraft or personal loan interest rates on a loan which is as safe for them as the housing loan they refused to give you.

Moral: make sure you get a loan whose interest rate matches your trustworthiness and capacity to repay. If you are a longstanding customer with a secure income, do not allow them to persuade you that the only type of loan they can give you is a high-interest personal loan.

Remember: they are not giving you independent advice, like a solicitor might. They are just loan salesmen. Like any other salesmen, they won't show you straight to the best-value car in the yard; they will first try to sell you the one giving them the biggest profit margin. *Caveat emptor.*

The rate of inflation and risk are two reasonably justifiable reasons for interest rates to vary. However, in contemporary Australia interest rates have served two more purposes which do not sit comfortably together. Banks have used high interest rates as one way of covering the bad debts from their debauches of the late 1980's, while governments have used them as an instrument of monetary policy - a means of constraining consumer expenditure and therefore inflation and encouraging a flow of funds from overseas to finance our foreign debt. Each has conveniently blamed the other for exorbitant interest rates. Meanwhile the rates have inhibited business investment and caused financial hardship and misery on a massive scale.

We have seen that the banks' power comes from their unique ability to create credit and destroy credit, to collateralise assets and dictate interest rates. The impact of all this was neatly summarised by an eminent Chancellor of the Exchequer in England, Mr. Richard McKenna, who said this:

> I am afraid that ordinary citizens will not like to be told that the banks can and do create and destroy money. And they who control the credit of the nation direct the policy of the governments and hold in the hollow of their hands the destiny of the people.

Paul McLean was a foundation member of the Australian Democrats, and was elected as a Senator for NSW in 1987. He came to prominence especially through his historic battle to get the now infamous "Westpac Letters" before the parliament and public scrutiny.
This resulted from his pursuit of bank malpractice and corruption in the Senate. He constantly called for a Senate inquiry, and moved a bill proposing a full Royal Commission into the banking system.]
At the time of his resignation from the Senate in August 1991, he had 600 cases of bank malpractice on his desk